Concise Explanatory Statement

Pursuant to RCW 34.05.325
Regarding Escrow Rulemaking

Under the authority of the Escrow Agent Registration Act, chapter 18.44 RCW ("Act"), the Department of Financial Institutions of the State of Washington ("Department") has proposed four rules in the following three areas: (1) quarterly reports, (2) the securities alternative to errors and omissions insurance, and (3) examination fees.

On November 19, 2003, the Department filed CR-101s with the Office of the Code Reviser (OCR), published in the Washington State Register (the Register) on December 3, 2003, under notices WSR 3-23-120 and WSR 3-23-121. The Department then filed CR-102 notices with OCR on September 22, 2004, published in the Register on October 6, 2004, under notices WSR 04-19-157 and WSR 04-19-158, scheduling a hearing at the Department on October 26, 2004. At that hearing, the Department began taking oral and written testimony on these proposed rules and then continued the hearing until December 8, 2004. The Department then filed CR-102 notices with OCR, published on November 17, 2004 in the WSR under notices WSR 04-22-086 and WSR 04-22-087, continuing the hearing until December 8, 2004, at the Department. A court reporter made a verbatim record of both hearings.

The Department has conducted the hearing and has received and considered various written and oral comments from interested parties ("Commenters").

1. **Agency reasons for adopting the rules.** RCW 34.05.325(6)(a)(i).

An escrow agent bears "a fiduciary relationship to all parties to the escrow" and owes a duty to "conduct the affairs with which he is entrusted with scrupulous honesty, skill, and diligence. *Nat'l Bank of Washington v. Equity Investors*, 81 Wn.2d 886, 910, 506 P.2d 20 (1973) (citations omitted). In chapter 18.44 RCW, the Legislature created a broad regulatory regime to ensure that escrow agents discharge these duties. *See Estate of Jordan*, 120 Wn.2d at 498 (summarizing agent licensing requirements; penalties for trust accounting violations; licensing of escrow officers, who pass a competence exam, to supervise all escrow transactions; bonding and insurance requirements). The escrow regulatory regime also already expressly includes detailed recordkeeping requirements and escrow agent audits and examinations. *See* RCW 18.44.400(1); chapter 208-680D WAC; RCW 18.44.121(5); WAC 208-680G-010.

The Legislature intended that the Act be interpreted and administered to protect escrow agent clients: "When read in its entirety, the Act reflects a legislative intent to protect clients of escrow agents." *Estate of Jordan v. Hartford Accident & Indem. Co.*, 120 Wn.2d 490, 497 (1993). To that end, under RCW 18.44.410 the Director "has the power and broad administrative discretion to administer and interpret this chapter to facilitate the delivery of services to citizens of this state by escrow agents." The Director believes adoption of these rules is consistent with that intent and within the power and discretion granted to her.

a. ***Securities alternative to errors and omissions insurance.***
WAC 208-680F-020 Errors and Omissions Policy – Securities Alternative.
WAC 208-680A-040 Definitions.

The present rulemaking amends WAC 208-680F-020 and WAC 208-680A-040 to clarify the types of securities that may be used in lieu of the errors and omission ("E&O") policy required by RCW 18.44.201. Under that section, an escrow agent must maintain a $50,000 E&O policy or deposit $50,000 in cash or securities in an approved depository.

The definition of "securities" previously in WAC 208-680A-040 allowed "any stock, treasury bill, bond, debenture or collateral trust certificate tendered in lieu of an errors or omissions policy." In addition to being overly broad, neither this definition nor WAC 460-680F-020 explicitly prohibited depositing securities issued by affiliates of the escrow agent. The prior rules virtually allowed any security, regardless of quality, volatility, or liquidity, to be substituted for an E&O policy. This compromises the protection of escrow agent clients.

Under the rule as adopted, the definition of "securities" in WAC 208-680A-040 is stricken and WAC 208-680F-020 is amended to require that any securities deposited in lieu of an E&O policy meet the definition of "investment securities" under WAC 208-512. Those regulations, which pertain to the type of securities in which banks and trust companies may invest, define "investment securities" to generally include certain government obligations and investment grade corporate securities. By limiting the securities an escrow agent may use to satisfy RCW 18.44.201 to such high-quality obligations, escrow agent clients will be better protected.

To the Division's knowledge, only one currently licensed escrow agent relies on WAC 208-680F-020. That agent, which maintains a $50,000 cash deposit in an approved depository, would not be impacted by the proposed changes to the rule.

b. ***Quarterly reporting.***
WAC 208-680E-025 Quarterly Reports.

This new rule, WAC 208-680E-025, mandates that escrow agents prepare and file quarterly reports on operations and trust accounting. The reports are due within 30 days following the end of each fiscal quarter. Failure to comply will be grounds for taking action to deny, suspend, decline to renew, or revoke an escrow agent's license.

- Quarterly reports will allow DFI to monitor escrow agents more effectively and efficiently.
- Under RCW 18.44.121, the Director is required to efficiently administer the statute such that the fees collected from licensees pay for the costs of administration. There are approximately 200 escrow agents, most of which are small businesses. Mandatory reports, while not a substitute for onsite inspections, will allow the director to better monitor the industry at a minor cost to the industry and DFI.

- Many escrow agents have been voluntarily submitting quarterly reports for several years. The old reports are cumbersome to complete and review and they require a great deal of supporting documentation. This rule would make reporting mandatory, but the new required report will be simple and much easier to complete.
- A draft copy of the new report form was shared with the attendees of the February 10, 2004, and April 6, 2004, Escrow Commission meetings, who commented that it appeared to be a much easier form to complete. Several agents have commented on the draft form. Those comments have been considered and incorporated as appropriate in the new form.
- The new report includes sections concerning trust account administration and reconciliation, operations (including changes in financial condition, legal proceedings, changes in ownership, locations of offices and records, and insurance coverage), and certain results of operations. In response to privacy concerns, the response to certain questions is optional.
- The new report does not require escrow agents to keep any records beyond those already required by statute and existing regulations.
- The new form has been implemented on a voluntary basis for the quarter-ended March 31, 2004. Several escrow agents have commented to the Division that the revised form is much easier to use.

c. ***Examination fees.***
WAC 208-680G-050 Examination and investigation fees and expense – Authority to retain specialists.

WAC 208-680G-050, as adopted in 2001, provided in subsection (1) that the director may retain attorneys, CPAs, and other professionals as examiners or investigators at the expense of the person that is the subject of the examination or investigation. Subsection (2) specifically provided that the expenses for required travel and services associated with an examination or investigation outside the state are to be borne by the person examined and investigated.

The prior language was potentially misleading. Subsection (1) clearly stated that the Department may seek reimbursement if it had hired outside professionals and specialists, but did not speak to reimbursement of the costs of examinations by the Department's examiners. Similarly, subsection (2) specifically set forth the reimbursement of travel related expenses, including per diem, for out-of-state examinations, but was silent as to in-state examinations. The amendments address the Department's examiners and in-state examinations.

Subsection (2) is amended to clearly state that examination and investigation related expenses are to be borne by the person examined or investigated, regardless of where that person is located. New subsection (3) provides examples of the expenses for which reimbursement may be owed. Such expenses include staff time and travel expenses. The subsection requires DFI to provide an invoice detailing such expenses at a reasonable time following the investigation or examination. Payment of the invoiced amount is due within 30 days of the invoice date.

RCW 18.44.121 states:

> The director shall charge and collect the following fees as established by rule…
>
> (5) An hourly audit fee. . . .
>
> In establishing these fees, the director shall set the fees at a sufficient level to defray the costs of administering this chapter.

Examination fees have not been charged to date and the other fees collected under the Act fall far short of defraying the costs of administering the Act. The Department took over the Act's administration on July 1, 1997. From that date though February 29, 2004, Act-related disbursements exceeded escrow-related revenues by over $1.3 million. Clearly, the prior fee structure did not satisfy the legislative mandate to make the escrow program self-supporting.

Amending WAC 208-680G-050 gives the Department clear authority to implement RCW 18.44.121(5) by clarifying the expenses for which it can seek reimbursement. With adoption of this rule, the Department will begin charging an hourly examination fee of $62.50 per hour. As detailed in the Small Business Economic Impact Statement (SBEIS), DFI initially will charge only for time spent on-site at the office of an escrow agent, which generally averages about 3 days, and will not charge for the substantial off-site time relating to preparation, debriefing, or writing up examination findings, which generally averages about 2 days. Assuming the Department is able to perform 66 examinations per year and that it will collect $1,500 for each exam, this rule would result in approximately $100,000 in additional revenue for the year following adoption of the rule. (It is likely that DFI will collect less revenue as some exams may take less than 3 days on-site.) This revenue will help defray the costs of running the escrow program, but is not sufficient to make the program self-supporting. Additional fees and/or fee increases will be necessary in the future.

2. **Description of, and reason, for differences between the text of proposed and adopted rules.** RCW 34.05.325(6)(a)(ii).

The proposed rule regarding quarterly reporting, WAC 208-680E-025, has been changed in the rule as adopted. The rule as adopted has added to subsection (1) the introductory clause, "For purposes of determining compliance with chapter 18.44 RCW and chapter 208-680 WAC." This language was added in response to comments from the escrow industry that the proposed rule should have additional limitations on the scope of the Department's ability to request information and that the Department should not attempt to use the rule to exceed its statutory authority. While the Department believes that this was implicit in the proposed rule, the Department has agreed to additional language that makes these limitations explicit.

There are no other textual differences between the proposed rules and the adopted rules.

3. Summary of and response to all comments. RCW 34.05.325(6)(a)(iii).

a. ***Securities alternative to errors and omissions insurance.***
WAC 208-680F-020 Errors and Omissions Policy – Securities Alternative.
WAC 208-680A-040 Definitions.

All Commenters who commented on the rule expressed general support for it as written. There were no specific comments or negative comments about it. Thus, the Department is adopting the text of the rule as proposed.

b. ***Quarterly reporting.***
WAC 208-680E-025 Quarterly Reports.

Some Commenters commented that the rule lacked specificity or limitations on the types of information to report. The rule specifies that the report must contain information relating to escrow agent "operations and trust account administration and reconciliation." These are the central areas in which the Department is charged with administering escrow agent compliance with the Act. In response to such comments, the Department also added in the final rule an introductory clause to subsection (1) clarifying that the report contents must related to a legitimate compliance purpose under the Act.

Some Commenters commented that the report should be limited to trust account activity, that the Department lacks statutory authority to request information outside of the trust account (absent indications of wrongdoing that would justify a subpoena), or that the words "operations and" be stricken from the proposed rule. The Act creates a broad regulatory regime that includes background checks on escrow agent ownership and designated escrow officers, requirements to maintain insurance coverage and other evidence of financial responsibility, requirements to keep and maintain adequate books and records, and licensing consequences for violations of the Act and other laws. In acting within its broad discretion to administer and enforce this regulatory regime, the Department hopes to use the quarterly report to gather information useful to measure compliance with such provisions.

Some Commenters commented that the rule will result in information that is not specific enough to be useful. Other Commenters commented that the current quarterly report form, while simpler than in prior reports, still too broadly requires trust account information and may require submission of a full trust account reconciliation, including adjustments and supporting documents. The Department intends to utilize, and if needed modify, a report form that will generate useful data. The existing rules have, for several years, required escrow agents to reconcile their trust accounts (including adjustments with supporting documents) and retain the reconciliations as permanent records. However, the current version of the quarterly report form does not require submission of such full reconciliations, and the Department does not anticipate changing the report to require such submissions. The Department also notes that the form is not part of the rule.

Some Commenters commented that an annual reporting requirement would provide the Department adequate information and reduce departmental overhead from processing the reports. Some Commenters suggested an annual certification, similar to that used by the Limited Practice Board. Timely, specific information is more helpful to the Department in monitoring escrow agents. Overhead relating to processing the current two-page report on a quarterly, rather than annual, basis appears minimal. Escrow agents are already required to keep records regarding all information requested in the current version of the quarterly report form.

Some Commenters indicated that other states using the approach of annual reporting require a review or audit by an independent accountant, a cost approximated at $3,000 for a trust account audit and perhaps another $3,000 if the business account were also included. While the current WAC 208-680G-050 allows the Department to retain independent auditors to carry on such audits, the Department notes the cost and does not wish to pursue this approach at this time.

Some Commenters commented that the report is not tied to the Department's examination cycle. A primary reason for the report is to acquire meaningful information that can be used to risk-rate escrow agents for purposes of scheduling examinations in the cycle.

Some Commenters commented that quarterly reporting is an added regulation that places escrow agents at a further competitive disadvantage with title companies and other competitors. Some Commenters commented that due to the increased costs of compliance an SBEIS should be prepared. The Department cannot impose licensing requirements on title companies, attorneys, and certain other competing entities. The Department believes that the costs of completing the quarterly report form will be minor. The current version of the form is two pages, primarily in a fill-in-the-blank or check-box format, and asks for information from records escrow agents are already required to keep.

Some Commenters commented that quarterly reporting is a great idea, particularly if it could cut down on audits. The Department agrees.

c. ***Examination fees.***
WAC 208-680G-050 Examination and investigation fees and expense – Authority to retain specialists.

Some Commenters commented that the Legislature did not intend that the Department charge for in-state examinations and that RCW 18.44.121 only authorizes charging fees for out-of-state examinations. Some Commenters argued that the word "shall" in RCW 18.44.121 is permissive and does not require the Department to charge any fees. Some Commenters also argued that a recent bill presented to the Legislature to create a fee for the designated escrow officer ("DEO") licensing designation did not get out of committee, indicating a legislative intent not to impose further costs on the escrow industry. As discussed above, the plain language of RCW 18.44.121 states that the "director shall charge and collect . . . (5) An hourly audit fee." The later sentence

in RCW 18.44.121(5) discussing out-of-state licensees elaborates on the audit fees in those circumstances but nowhere purports to limit the fee for in-state licensees. Regardless of whether the word "shall" is mandatory or permissive, the rule would not exceed the Department's statutory authority. Whether or not a bill about fees for DEO licenses left committee appears unrelated to the intent of the legislature that enacted RCW 18.44.121(5).

Some Commenters commented that paying examination fees is an added cost on escrow agents, most of whom are small businesses, who already pay for licensing fees, E&O insurance, fidelity bonds, and sales taxes. Some Commenters commented that title companies, attorneys, and others competing in the closing industry are often large businesses, do not pay such costs, and should be subject to identical regulation. This appears to be a policy decision the Legislature has made in excepting such competitors from the Act's licensing requirements, RCW 18.44.021, and in providing that the Department "shall" charge and collect an audit fee. RCW 18.44.121. The Department believes that its substantial mitigating proposals, including initially charging an hourly examination fee of $62.50 (rather than an hourly rate for all associated overhead) and only for on-site time at an escrow agent's office (which excludes substantial time relating to preparation, travel, report-writing, follow up, and other off-site time), are a reasonable way to lessen the cost of exams while still meaningfully addressing the escrow program deficit. The Department also believes that escrow agents can budget for exams and are in a unique position to control their costs. For instance, escrow agents should expect faster, cheaper exams if they keep clean books and records and/or prepare for and facilitate the exam.

Some Commenters commented that the Department does not have authority to conduct, or that examination fees should not be charged for, examinations that go into non-trust account matters (absent grounds similar to that for a subpoena). This rule proposal does not address the scope of examinations; it addresses charging for examinations. The scope of examinations has been settled in rule for several years now, WAC 208-680G-010, and is a matter vested in the broad discretion of the Director of the Department. The Department notes, though, that it primarily examines for trust account and related information in client transaction files, absent reasons to look at other areas.

Some Commenters commented that the rule does not specifically list or limit what may be charged for and does not require an itemization or invoicing of examination charges. Subsection (3) of the rule explains what expenses may be charged for and provides that escrow agents will receive an invoice. Presently, the Department intends to charge only for its on-site exam time.

Some Commenters commented that routine examinations should take one day, particularly when limited to trust account matters. Some Commenters commented that the Department's examiners may extend the time of exams due to factors such as newness to the escrow industry or lack of familiarity with manual accounting systems. In the Department's experience, a thorough examination of escrow agents – which vary in size, transaction volume, recordkeeping practices, or conduct during the examination – takes more than one day. The Department will make every reasonable to shorten the length of examinations without sacrificing their

thoroughness. The Department maintains annual performance measures for its examiners and believes that its two full-time, dedicated escrow examiners will complete exams of any system in a reasonable time by drawing upon their substantial accounting background in the real estate, title company, and lending industries.

Some Commenters questioned whether the Department's examiners (1) earn a salary comparable to similar auditors, or (2) add value to the escrow agent insofar as the examiners are not accountants hired by the escrow agent. The Department believes its examiners are appropriately paid. The Escrow Commission has advised us that exams are important to ensure the public confidence in the escrow industry.

Some Commenters commented that the SBEIS was based on the data of a limited number of responding businesses. Some Commenters noted that the Department did not incorporate into the SBEIS data from the voluntarily submitted quarterly reports the Department has received. The Department properly sent the SBEIS survey to all escrow agent licensees and incorporated all the responses received. Incorporating data from the voluntarily submitted quarterly reports is not required by the Regulatory Fairness Act, RCW 19.85, and may raise statistical problems that could skew the SBEIS.

Some Commenters commented that the SBEIS shows that exam costs can be a large portion of net income for many escrow agents. Because exam cost is a business expense, comparing it only to net income (rather than revenues) may be misleading. Furthermore, the SBEIS data should be read with the understanding that (1) exam costs should generally be annualized over the exam cycle; (2) the Department's mitigation will reduce the cost of exams by only charging for on-site time; and (3) escrow agents with lower income (or revenues) appear likely to have lower escrow and trust account volume, which should reduce the time and cost of examination.

Some Commenters commented that the mitigating measures in the SBEIS should become part of the rule. Some Commenters noted that because the mitigation is limited to the first year, it only benefits those examined in the first year. The Department would like to avoid unnecessary inflexibility. The Department believes that its proposed mitigation allows a reasonable time for escrow agents to budget for examination expenses. Presently, the Department does not intend to charge for off-site examination time at any point in the foreseeable future.

Some Commenters commented that the 3-year exam cycle is unnecessary for mature and stable escrow agents. Some Commenters commented on the exam cycle's presumption that examiners will conduct 33 exams in a year. The exam cycle is not the direct subject of the proposed rulemaking, but the Department does intend to move toward a risk-rated exam cycle that is flexible enough to allow examiners to conduct cause examinations, assist with administrative orders or hearings, use vacation or sick leave, receive training, and attend to other factors.

Some Commenters commented that the Department does not need to ensure that the escrow program is self-supporting, that public funds should pay for escrow regulation, and that the

Department does not budget or report for its various programs in a program-by-program manner. The Legislature has not made the Department a part of the general fund. The Department's programs must be self-supporting. For the escrow program specifically, the Legislature has instructed the Department to "set the fees at a sufficient level to defray the costs of administering this chapter." RCW 18.44.121. The Department has made available a financial report showing that the escrow program has, since the Department began administering it in July 1997, amassed a $1.3 million total deficit.

Some Commenters suggested, as an alternative to exam fees, an increase in licensing fees. The Department believes that charging a fee for a discrete function (exams) to discrete licensees involved in it (those examined) is a more transparent and efficient approach to regulation.

Some Commenters suggested, as an alternative to a $62.50 hourly exam fee as per the SBEIS, that the Department charge $35 per hour capped at $1,000 in a three-year period (removing the cap if legal or enforcement action became necessary, but not for minor corrections). The $62.50 hourly rate in the SBEIS generally traces the costs of examinations. A $35 rate is drastically below the rate for examiners in other financial service industries and for escrow examiners in other states. As to the $1,000 cap, the Department proposed a capped exam fee model to the Escrow Commission at an executive session, but the Commission rejected the concept, without disapproval, as tending to favor larger escrow agents and those with disorderly books, which may take longer to examine. Other Commenters have criticized the concept of a cap as disproportionately impacting small businesses. It is unclear if there is meaningful industry support for the concept of the cap.

Some Commenters questioned comparing examination costs to that of other states without comparing the other costs of Washington regulation, such as errors and omissions insurance, fidelity bonding, and licensing costs. The Department has done so and believes any comparisons it has made are reasonable.

Some Commenters commented that the Department should charge only for time beyond the first eight hours, beyond the time normally expected, or when a serious problem (defalcation, commingling, etc.) is detected. The Department has proposed mitigation that essentially already gives two free days of examination. The approach of additional free time was considered and rejected, without disapproval, at the executive session of the Escrow Commission. This would not adequately address the revenue needs of the escrow program.

Some Commenters suggested a dispute resolution mechanism to contest specific charges, such as an oversight committee. An oversight committee appears to be an expensive and impracticable approach. The Department welcomes any question from an agent about specific disputed items.

Some Commenters commented that an annual $1500 exam charge is too expensive for small businesses. Annual exam fees are unlikely given the 3-year exam cycle.

Some Commenters doubted that the Department would retain outside specialists and suggested the rule was, therefore, ambiguous or confusing. Other Commenters suggested that the Department should not retain such specialists. Existing WAC 208-680G-050 allows the retention of outside specialists, paid for by the subject escrow agent. This is not the subject of the current rulemaking proposals.

Some Commenters commented that an SBEIS was not conducted and/or did not outline any mitigation. An SBEIS was prepared and discussed mitigation for several pages.

Some Commenters commented that escrow agents with Limited Practice Officers (LPOs) regulated by the Limited Practice Board of the Washington State Bar Association should not be subject to overlapping regulation. The Department is unaware whether the LPO Board has examined any escrow agent and, in any event, cannot promulgate LPO rules.

Some Commenters proposed an audited financial statement requirement in lieu of examinations. Other Commenters commented that such an approach could easily exceed $3,000 per agent. Some Commenters suggested that mandatory, detailed, sworn quarterly reporting be used as an alternative to exams. It is unclear if there is meaningful industry consensus on an audited financial statement requirement, and the Department's experience with stringent voluntary reporting suggests that stringent mandatory reporting is impractical. The Escrow Commission has also informed us that on-site examinations are a critical component of escrow regulation.

Some Commenters commented that charging for exams may be unfair for escrow agents in Eastern Washington. The Department is intending to charge, for the foreseeable future, only for on-site exam time.

d. *General comments that appear unrelated to the proposed rules.*

The Department also received various general comments that appear unrelated to any of the proposed rules, including comments regarding: predetermination to adopt rules, notice of the rulemaking hearing, the gubernatorial election, general departmental treatment of licensees, the 4th Amendment, a different approach to bonding, and background and credit checks on license applicants. The Department has not undertaken to respond to comments unrelated to the proposed rules.

CONCLUSION

The Department believes that the rules it has proposed and adopted are an appropriate exercise of the broad discretion conferred by the Act. The rules reflect the clear intent of the Legislature: "to protect clients of escrow agents." *Estate of Jordan*, 120 Wn.2d at 497.